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# RESEARCH ON MONEY AND FINANCE

Discussion Paper no 18

## **Fiscal Crisis in Europe or a Crisis of Distribution?**

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# **Fiscal Crisis in Europe or a Crisis of Distribution?**<sup>1</sup>

## **Abstract**

We are in a new episode of the global crisis: the struggle to distribute the costs of the crisis. The financial speculators and corporations are relabeling the crisis as a “sovereign debt crisis” and pressurizing the governments in diverse countries ranging from Greece to Britain to cut spending to avoid taxes on their profits and wealth. In Europe the crisis laid bare the historical divergences. At the root of the problem is the neoliberal model which turned the periphery of Europe into markets for the core.

The EU’s current policies are still assuming that the problem is a lack of fiscal discipline and do not question the structural reasons behind the deficits. The crisis calls for a major change in policy framework within Europe. This is a crisis of distribution and a reversal of inequality at the expense of labour is the only real solution.

Keywords: crisis, distribution, sovereign debt, Europe

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## 1. Introduction

We are in a new episode of the global crisis: the struggle to distribute the costs of the crisis. This crisis has been an outcome of increased exploitation and inequality, since the post-1980s across the globe. Neoliberalism tried to solve the crisis of the golden age of capitalism via a major attack on labour. The outcome was a dramatic decline in labour's bargaining power and labour's share in income across the globe in the post-1980s. However, the decline in the labour share has been the source of a *potential realization crisis* for the system –one of the major sources of crisis in capitalism according to Marxian economics. The decline in the purchasing power of workers limited their potential to consume. Demand deficiency and financial deregulation reduced investments despite increasing profitability. Thus neoliberalism only replaced the profit squeeze and over-accumulation crisis of the 1970s with the realization problem. Financialisation and debt-led consumption seemed to offer a short-term solution to this potential realization crisis. Since summer 2007 this solution has also collapsed. The crisis was tamed via major banking rescue packages and fiscal stimuli. Now the financial speculators and corporations are relabeling the crisis as a “sovereign debt crisis” and pressurizing the governments in diverse countries ranging from Greece to Britain to cut spending to avoid taxes on their profits and wealth. The pressure on wages associated with budget cuts is great news for the corporations! However the push for public debt reduction is the biggest threat to recovery.

The realization crisis at the origin of the crisis based on wage suppression was deeply connected to global imbalances. In the European context, the wage suppression strategy and current account surpluses of Germany in particular created imbalances within Europe in the form of current account deficits, public or private debt in the periphery of the Eurozone, in particular in Greece, Portugal, Spain, and Ireland or in Eastern Europe, in particular in Hungary, Baltic States, Romania, and Bulgaria. The crisis laid bare the historical divergences within Europe, and led to a European crisis and a new stage in the global crisis. The restrained policy framework, which is based on a strict inflation targeting, and which lacks a common fiscal policy, is the root of the problem, as it has failed to generate convergence within the EU in the first place. In countries of the periphery like Greece where both public debt and budget deficit to GDP ratio is high and is coupled with a high current account deficit, the attack of the speculators asking dramatically higher yields has brought the country to the edge of a sovereign debt crisis in 2010. Indeed before Greece, in 2009 Hungary, Baltic States, and Romania were under attack. It looked as if the euro saved Slovakia and Slovenia from the turbulences in the currency markets, but their problem will be a permanent loss of

international competitiveness as is unfortunately illustrated by the problems of the periphery of the Eurozone. Initially Eastern Europe was seen the only problem zone in Europe. However, together with Greece, the attention of the speculators turned to the public debt and deficits in Portugal, Spain, Ireland, and then towards the core to Italy, Britain and Belgium. Now market pressures are threatening convergence and social cohesion both in the East and the West.

The governments agreeing to the cuts are avoiding taxing the beneficiaries of neoliberal policies and the main creators of the crisis. The public debt would not be there, if it were not for the bank rescue packages, counter-cyclical fiscal stimuli, and the loss of tax revenues during the crisis. Finally, the crisis would not have happened without the major pro-capital redistribution and financialisation. Thus this is a crisis of distribution and a reversal of inequality at the expense of labour is the only real solution, which in turn connects the demands for full employment and equality with an agenda for change beyond capitalism.

The rest of the paper is structured as follows: Section two discusses the crisis in Western Europe in both the core and the periphery. Section three presents the evidence about Eastern Europe. Section four concludes with an alternative policy framework for Europe.

## **2. Western Europe: crisis and economic policy**

Although the crisis originated in the US, it spread quickly to Europe due to the exposure of the European Banks to the toxic assets, and the recession has been deeper in Europe. The difference in the depth of the crisis between the US and Europe can be explained by the larger size of the fiscal stimulus plan as well as the faster reaction in the US in terms of both monetary and fiscal policy compared to Europe.

There were also important divergences within the core of Europe as well as between the core and the periphery. In the core, Britain had a deep recession due to dependence on financial sector, overextended banks and over-indebted private sector, and housing bubble. The recession in Britain lasted longer than in any other G7 countries, where GDP contracted by 6.2% between early 2008 and the third quarter of 2009. German and Italian GDP declined by 4.9% and 5.0% respectively in 2009, while French GDP contracted by just 2.6% in 2009. Germany did not have a household debt problem, but it is particularly suffering from the curse of its neo-mercantilist strategy, i.e. growth based on export markets via wage dumping, as the export markets are shrinking. Contrary to Germany, in France a better developed system of automatic stabilizers, a larger state sector and a better position in terms of income inequality made the conditions of the crisis more moderate at the onset, since the weakening of demand was less important (Fitoussi and Saraceno, 2010).

In the periphery of Europe, Ireland, with its disproportionately large banking sector and the bust of its housing bubble; and Spain, with the collapse of the housing bubble and the consequent contraction in construction, are both expected to be in continuous recession in 2010, with limited capacity to reverse course. The contraction in Ireland's GDP in 2009 has reached 7.47%. Most importantly the imbalances between the core and periphery of Europe, and the limited fiscal capacity of the periphery to tame the crisis evolved into a sovereign debt crisis in Greece followed by Portugal, Spain, and Ireland at the end of 2009 with severe implications for growth in 2010.

In the Eurozone in particular the Stability and Growth Pact and the statute of the ECB restrained discretionary macroeconomic policies during the crisis. Monetary policy response remained more restrictive in Europe than in the US (Fitoussi and Saraceno, 2010). The creativity in terms of the injection of liquidity into the system through quantitative easing has also not been able to reverse the credit crunch, since the banks hoarded liquidity to improve their balance sheet. The government conditions for support to banks have been weak, which does not punish the liquidity hoarding behaviour of banks.

The ratio of the financial rescue package in 2008 reached 28.6% of GDP in Britain and to an unforeseen level of 235.7% in Ireland (OECD, 2009).<sup>2</sup> Although continental European Banks claim to have a more conservative banking and credit policy at home than the Anglo-Saxon banks, they also proved to be prone to significant risks via purchasing of CDOs of US banks even in Germany or via excessive credit expansion in Eastern Europe as in the case of Austria, Sweden, Italy, and partly Greece. Austria had a financial rescue package of 36.9% of its GDP and Sweden 50.5% in 2008.

Fiscal policy has also been significantly less expansionary in Europe than in the US. Mainstream economists (e.g. OECD, 2009) emphasize that the automatic stabilizers like unemployment insurance benefits in the EU, particularly in the northern EU, are almost 3 times the fiscal stimulus plans, and thereby the total size of the fiscal stimuli were adequate. However the US total fiscal stimulus including automatic and discretionary measures is still above 10% of GDP as opposed to a mere 6% in Germany in 2008-10 (OECD, 2009).<sup>3</sup> The size of the total fiscal stimulus exceeds that in the US in only 4 EU countries (Sweden, Luxemburg, Spain, Denmark).

Apart from the size of the fiscal stimuli, one major problem in the EU has been the absence of a coordinated policy reaction. The ECB, which acted as a lender of last resort to

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<sup>2</sup> Although guarantees in the financial packages might never be used, the ratios are still indicative.

<sup>3</sup> The ratio of automatic and discretionary fiscal impulse cumulated over the period 2008-10 as a percent of 2008 GDP.

the private European Banks, did not fulfil the same function in the case of the Eurozone governments, and remained loyal to the neoliberal policy framework of the EU treaties, which did not allow it to buy the government bonds of the Member States (MS). Even when countries of the periphery faced excessively high interest rates and borrowing hardships, ECB statute was preserved; thus the function of lender of last resort to the governments was not permitted. This course was abandoned only in May 2010 when the markets speculated fiercely about a default in Greece. In 2007-10, different from the US or Britain, Eurozone governments had to finance their rescue plans in financial markets, which has raised the costs of the rescue packages. Ironically the ECB's quantitative easing policy helped the banks to acquire cheap funding for their operations. From 2007 summer to October 2008 European banks shifted their lending towards the peripheral countries in the Eurozone, assuming that the toxic assets in those countries' banks were limited (Lapavitsas et al, 2010). Government bonds with higher yields in the periphery were also seen as an attractive and safe alternative. More ironically, it was the same banks that later fled to the US government bonds, and cut lending to the periphery in 2009 as they became more risk averse. These same banks were not only bailed out by the ECB, but also the macroeconomic environment in which they are operating was supported by expansionary fiscal policy to prevent the recession turning into a great depression. Eventually the rescue packages, fiscal expansion, and the decline in tax revenues due to the recession led to a significant increase in budget deficit. Now it is again the same banks who are asking for high risk premiums from the governments with high budget deficits and public debt. They are asking for cuts in spending, in particular in public wages and employment, and threatening to stop lending to the governments who fail to do so.

### **2.1. Core and the periphery in Western Europe**

At the root of the problem is the neoliberal model that turned the periphery of Europe to markets for the core countries without any prospect of catching up. The lack of a sufficiently large European budget and significant fiscal transfers targeting productive investments in the periphery led to persistent differentials in productivity. Stability and Growth Pact as well as EU competition regulations limited the area for manoeuvre for the implementation of national industrial policy. In the absence of industrial policy and productive investments to boost productivity, and unable to devalue, the strategy of competitiveness was based mainly on wage moderation, and increased deregulation and precarisation in the labour markets, which further eroded labour's bargaining power throughout the EU. Overall labour's share in income declined sharply in that period (see Figure 1). However, wage moderation also did not save the periphery of the Eurozone, like



Greece, Portugal, Ireland, Spain, since Germany was engaged in a much more aggressive wage and labour market policy.

Figure 1

Between 2000-2007 unit labour costs declined by 0.2% a year in Germany while rising by 2% in France, 2.3% in Britain, between 3.2% and 3.7% in Italy, Spain, Ireland, and Greece. In particular in the periphery nominal labour costs have increased faster than in Germany due to a higher rate of inflation. This however does not mean that there was no wage moderation in these countries: in the 1990s and 2000s productivity increases exceeded changes in real wages in all Western EU countries. In Germany as well as in Italy, Spain, and Portugal real wages even declined in the 2000s, with the gap being largest in Germany (see Table 1). The gap between wages and productivity in Germany was due to real wage decline, and not necessarily high productivity. Indeed the productivity increase in Germany has been quite modest; e.g. lower than in Britain, Ireland, Greece, and Portugal in the period of 1991-2007. The phenomenal competitive advantage of Germany was simply due to wage suppression rather than increasing productivity. The low investments despite a high profit share explain the stagnant productivity and low rates of GDP growth in Germany. Most strikingly, the real wage decline in Germany in the 2000s went along with the worst employment performance in Western EU (see Table 1). This again proves that suppressing wages do not necessarily lead to high investment, employment, and productivity. Moreover with significantly lower wages Eastern Europe was a much more attractive location, if there were any investment motives in search for lower wages. German case is also in striking contrast to France, where real wage growth has more or less kept up with productivity. France did not have Germany's export boom, but domestic demand and employment growth has been much stronger.

Table 1

With weak domestic demand due to low wages, exports were the main source of growth in Germany, but this has led to the current account surpluses at the expense of the current account deficits in periphery of the EU. Italy as a core country has also faced the same fate of high current account deficits despite real wage losses due to falling productivity. Indeed the dominant narrative that the peripheral countries enjoyed low interest rates thanks to their membership in the Eurozone, and thereby avoided fiscal discipline should be reversed: German firms enjoyed a high competitiveness thanks to their low wages and the inability of the peripheral countries in the Eurozone to devalue. This has been detrimental for the exports of the peripheral countries due to both loss of competitiveness and the contraction

of the domestic demand in Germany. Indeed Germany is like the China of Europe with large current account surplus, high savings and low domestic demand. Thanks to its political power there is much less talk about the competition policies of Germany, albeit rising complaints from France recently. This neo-mercantilist policy has also been a model for some other countries like Austria and the Netherlands, which also have high current account surpluses. In the countries of the periphery consumption led by private debt has filled in the gap that low exports and high imports have created. Construction boom, real estate bubbles, and private debt have been a typical feature particularly in Spain and Ireland. In Greece and to a lesser extent Portugal fiscal deficit also played a compensating role along with the debt of the households and corporations.

## **2.2 From wage suppression to sovereign debt crisis**

As a result of these diverging experiences, the countries in the core vs. the periphery of the EU experienced the crisis as an asymmetric shock. This is the background of the sovereign debt crisis in the periphery, as it was unleashed in Greece in December 2009.

Following speculations about Greece's default and exit from the Euro, the Eurozone governments' first decision came at the end of March 2010 after months of hesitation and worries about Germany's constitution court, who could rule out any bailout as being against the treaties. As part of a package involving substantial IMF financing and a majority of European financing via coordinated bi-lateral loans, Euro area member states declared their readiness to support Greece subject to strong conditionality based on an assessment by the European Commission and the ECB and at a penalty interest rate. In April 2010, as the IMF and the Eurozone technocrats were bargaining the conditions of the credit, the interest rate of the two-year Greek government bonds increased to 19%; the cost of the Credit Default Swaps (CDS) for the Greek bonds hiked as speculation about default spread; and Greek bonds were downgraded to junk status. The contagion started to threaten Spain and Portugal, whose bonds also downgraded slightly; in Ireland the interest rates on bonds increased and eyes turned to the sovereign debt problem in the core countries like Italy, Belgium, Britain, and even the US. Worries also rose about the solvency of the private banks holding government bonds. Under pressure the initially spelt amount of €30 billion turned out to be the first part of a larger 3-year bailout package of €110 billion. EU unveiled later in May a further surprise package of €500 billion to be supported by a €250 billion IMF facility to defend all Eurozone countries. The Eurozone governments are indeed protecting their own banks that are holding Greek bonds against a default; the bulk of the Greek bonds are held by German and French banks (The Economist, 2010a).

The ECB's initial response was only to announce in March 2010 that it will continue to accept from the banks bonds with ratings as low as triple-B-minus as collateral; later it even accepted the Greek bonds after they were downgraded to Junk status.<sup>4</sup> The rating of the private agencies was of course still the basis. However in May under the pressure of banks and the Commission ECB finally made a U-turn and launched a programme of buying up the bonds of the peripheral Eurozone countries.

Germany, backed by Netherlands, Austria, and Finland, all current account surplus countries, initially resisted the €750 billion package. Weber, Bundesbank president, did not hide his critique of ECB's new decision. The package was pushed by France and the deficit countries like Spain, Italy, Portugal, and most importantly by the external intervention of the US with the fear of a second "Lehman Brothers" turning point in the global economy. Interestingly the information about Sarkozy's threat to leave the Euro to stop Merkel's block was leaked to the press by the Spanish Prime Minister Zapatero's colleagues. Barroso, the head of the European Commission, is also pushing for moving the monetary union in the direction of a fiscal union. Life for Germany's ruling elite is not easy: Merkel's party lost in a local state election amid the Greek crisis. Her liberal coalition partner (FDP) complains that transfers to imprudent Eurozone members have a higher priority than tax cuts. The social democrats (SPD) oppose that banks are again being bailed out. The German technocracy is expressing its fears about fiscal federalism and the euro turning into a French Euro; German media is spreading fears of inflation. Sarkozy, who for now seems to be the winner, is also not free of troubles. IMF's eager involvement, which was supported by Germany, is improving Strauss-Kahn's profile, who may be considering a run against Sarkozy for the French presidency. Outside the Eurozone, Britain is also troubled: it is trying to stay out of the large defence scheme; however this might be premature and ignorant about a future attack to the Pound. Financial regulation is another issue that Britain tries to resist to protect the City of London.

The role model pointed out by the EU politicians for Greece is Ireland: Ireland has already smashed public sector wages between 5-15%, cut social welfare spending and other spending in order to decrease its budget deficit from 12.5% in 2009 to 10% in 2011 and 2.9% in 2014. These brutal spending cuts and the detrimental pro-cyclical fiscal policy in Ireland have been praised, since they have restored market confidence without aid from the EU. However this did not prevent the speculators from asking higher interest rates on Irish bonds after the contagion effects of the crisis in Greece.

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<sup>4</sup> The ECB had lowered the threshold for acceptable assets as collateral to triple-B-minus from A-minus in order to ensure that banks had access to sufficient amounts of ECB credit.

The other role model celebrated for its self-discipline has been Latvia, who has managed a real devaluation not by abandoning its pegged exchange rate, but by deep cuts in wages and public spending, at the cost of 25.0% loss of GDP in two years and 22.9% unemployment in 2009.

Greece is now pushed to cut its budget deficit from 13.6% of GDP in 2009 to 3% in 2013 via dramatic cuts in spending, public sector wages and pension, increase in retirement age, tax hikes along with a fight against tax evasion. The bulk of the austerity measures will hurt the wage earners in the private as well as the public sector, as the wage cuts in the public sector play a signal role for bargaining. Cuts in public services will also increase the cost of living further. However there is a major inconsistency in this austerity plan: as the recession becomes deeper, tax revenues will become lower and despite severe cuts, budget deficit might not improve as much as planned. The high interest rates are also increasing the problem of insolvency further. If the interest rate on public debt is higher than the growth rate, the stock of government debt will rise as a ratio to GDP unless the government runs a very high primary budget surplus (budget balance excluding interest payments). The Economist (2010b) estimates that nominal GDP of Greece will be 5% lower by 2014, if it is to reduce its budget deficit to 2.6% of GDP by 2014, which would however still mean a debt to GDP ratio of 153%. Thus it is unclear how the austerity plan will rescue Greece from insolvency.

Portugal and Spain have also committed to austerity packages with higher tax on consumption and wage cuts.

Outside the Eurozone, Britain is another major plot for cuts in the budget deficit. The election campaign in 2010 has witnessed a race between the conservatives and the Labour Party on how and when to reduce the budget deficit. Although the deficit is one of the highest in the EU with a ratio of 11.7% to GDP in 2009, the entire buzz about Britain's public debt is surprising when one considers that average maturity of the debt is 13.7 years, the interest rate is at historical lows, and the ratio of debt to GDP is 68.6%. Moreover part of the increase in the public debt to GDP ratio is because of a lower GDP in both actual and potential terms due to the decline in the productive capacity of the private sector. At the end of 2009 the recession turned into stagnation; public sector cuts at this stage may turn stagnation into a double dip recession. The estimates show that the GDP in 2013 will be about 12% lower than it would have been if the pre-2007 experience before the crisis had continued (Arestis and Sawyer, 2009). Under these circumstances the talk about a fiscal crisis looks more like an excuse of the business lobbies to avoid tax increases to finance the budget deficit, and make the wage earners pay the costs of the crisis through cuts in income, jobs, and social services, and to

create a situation of “national emergency” to smash the remaining power of the trade unions in the public sector.

The speculators now worry that these measures are not a solution to the problems: first they think that the default of Greece is inevitable given the popular resistance, the size of the debt and the recession. Second, in a schizoid way, they are also worried that austerity measures will deepen the recession in not only Greece but many other rich countries, create a double dip in the global economy, decrease tax revenues, and make it even harder to pay the debt back.

A long recession seems very likely without the support of strong fiscal stimuli. The uncertainty about the strength of the recovery is making new investments as well as hirings less likely. Decline in income and confidence, job losses, the pressure to pay back debt is restraining household consumption. Both investments and consumption will not return back to normal even when the banks relax credit. The presumed positive effect of reduced budget deficit on private investments is based on the argument that lower government borrowing leads to lower interest rates and a higher private investment and spending. Under the current conditions where consumers and firms are trying to reduce their debt and interest rates are already low, this channel has no relevance. Quite on the contrary public investment could increase the productivity and potential output of the economy, crowd in private investment and therefore offer a long term solution to the problem of debt.

The decision of the EU is assuming that the problem is a lack of fiscal discipline and repeats the old faith in strengthening the surveillance of budget deficits; it does not question the reasons behind the deficits; it ignores all the structural problems regarding divergence in productivity, imbalances in current accounts due to the “beggar my neighbour” policies of Germany. The austerity packages throughout the EU are pushing the countries into a model of chronically low internal demand based on low wages. The deflationary consequences of wage cuts may turn the problem of debt to insolvency for private as well as the public sector. In the past in Germany low domestic demand was substituted by high demand for exports. But it is not possible to turn the whole Eurozone into a German model based on wage suppression and austerity, since without the deficits of the periphery German export market will also stagnate. Particularly for the periphery of Europe contraction in domestic demand means prolonged recession.

Real wages have already declined in 2008-09 compared to 2007 in Britain, Germany, Italy, and Sweden. Ireland, Greece, Portugal, and Spain are preparing for severe real wage cuts in 2010. Sharp and long-lasting increases in unemployment are likely to make the wage

losses much stronger. The share of wages in GDP has already declined in 2009 in Spain and Ireland; the counter-cyclical increase in the wage share in other countries is rather a symptom of the productivity decreases. The case of Japan shows that during the initial phase of a deflationary crisis (or a long-lasting recession), labour's income share either stagnates or slightly increases, but as the recession and deflation persists, even nominal wage declines take place; in Japan the wage share declined by 8.9% between 1992 and in 2007. The decline in the wages in Eastern Europe will also add further international competitive pressures on wages in Western Europe.

Unemployment has increased in 2009 by 1.9%-points in the Euro area, 2.3%-points in Britain. Particularly high increases took place in Ireland and Spain (6.0 and 6.7%- points respectively) due to the collapse of the construction and loss of temporary jobs. Unemployment is expected to increase further and display a significant persistence. ILO (2010) estimates that employment rates will not return back to the pre-crisis levels before 2014. In all countries working hours decreased more than employment, and there has been a rise in part-time employment. Some countries like France, Germany, Austria, and Netherlands have had short working time arrangements, supported by government subsidies. However the short working time arrangements will eventually be terminated as the financial markets are increasing the pressure over governments to decrease public debt. ILO (2010) estimates that 5 million additional jobs could be lost if these practices were discontinued. This may spread the problem of unemployment from lower skilled temporary workers to higher skilled workers. Moreover firms might want to make use of the recession to rationalize a strategy of increasing productivity and start a new wave of firing or engage in hiring freezes long after the recovery. If firms increase the working hours and delay hiring, this would worsen the job chances of the unemployed and the young first time job seekers. The crisis then will lead to an increase in long term unemployment as well as discouraged workers who drop out of the labour market. There are also structural problems of unemployment in sectors like automotive industry and construction, where the crisis only uncovered the already existing bottlenecks. Recovery of the aggregate economy will not necessarily create jobs in these sectors.

### **3. Eastern Europe: forgotten fragilities**

Eastern European New Member States (NMS) are being severely affected by the credit crash and capital outflows, and possible currency crisis accompanying the banking crisis, although the recent problems in the old periphery countries of Europe removed the focus on these countries as Europe's "sub-prime". After the initial transition shock and a decade of restructuring, these countries will once again face the costs of integration to unregulated

global markets. The early optimism about the decoupling of the East from the West proved to be wrong. The hopes for soft landing were replaced by fears of hard landing in 2008 autumn; the conventional wisdom of the markets shifted from optimism to pessimism, and the EU-anchor seems to be helping only to a limited extent. The fundamental problem of the region was an excessive dependency on foreign capital flows, and as a typical consequence of this a bust episode following the boom was an unavoidable outcome of capital flow reversals. Many authors, including myself, were pointing at these risks, and a bust did happen again (Onaran, 2007; Becker, 2007; Goldstein, 2005). If it were not due to the global crisis, this could have been triggered through traditional channels of expectations regarding the sustainability of the overvalued exchange rate and high current account deficits. Ignoring the possibility of capital outflow was gambling in policy making. This behaviour is like ignoring a gas leakage in your house, and choosing a “wait and see” strategy, rather than trying to fix the leakage. Markets in the last instance could not prevent the systemic risk, but only postponed it and made it bigger.

The difference of this crisis compared to the former boom-bust cycles in the periphery is that it is a global and not a regional crisis. It has originated from the core, but the consequences for the periphery of Europe are heavier. The credit crunch has a global dimension, which makes the usual capital inflows after the bust phase unlikely. Again due to the global character of the crisis, the export markets have severely contracted, and depreciation, which is a usual outcome of boom-bust cycles, now only have the negative balance sheet effects, and no positive demand effect. The austerity packages in Western Europe further threatens recovery. The extent of debt-led growth, and household and private sector debt, most of all in foreign currency, is also increasing the risks more than the former crises with wider social implications of depreciation.

The slowdown in global demand, the decline in FDI inflows, portfolio investment outflows, the contraction in remittances, and credit crash are effecting all the Eastern European countries, but the degree of accumulated imbalances including current account deficits, exchange rate appreciation, housing market boom, and foreign-currency denominated private debt determine the differences in the depth of the effects among these countries. Baltic Countries, Hungary, Romania, Bulgaria, are more exposed than Poland, Czech Republic, Slovenia, and Slovakia. In Hungary public sector, households as well as firms are indebted. But even Poland, Czech Republic, Slovenia, and Slovakia are suffering from the contagion effects, the slowdown in global demand, and the decline in FDI inflows. Excessive dependence on export markets and a dangerous specialization in the automobile industry as in the case of Slovakia in particular, but also in the Czech Republic and Slovenia turns out to be

major risks. Poland is experiencing only stagnation rather than a recession thanks to its more diversified market and large domestic economy with a lower trade volume as a ratio to GDP. However, growth rates in Poland only accelerated in 2006; thus the boom had not created all the fragilities yet. Both Slovakia and Slovenia have escaped turbulences in the currency markets by adopting the Euro; however their problem will be a permanent loss of international competitiveness relative to their Eastern European competitors, whose currencies depreciate. To avoid speculation, Estonia is also willing to opt for the lesser evil, i.e. to adopt the Euro.

The myth that these countries would not experience bottlenecks regarding the current account deficits thanks to FDI being a major source of finance of the deficit also proved to be wrong. It is true that FDI is still more robust than the other capital flows, but FDI inflows have also fallen significantly reaching the level of 2001-2002 (Hunya, 2009). Although the current account deficits are also falling because of lower imports, FDI is now financing a declining part of the deficits. Furthermore FDI not only finances but also creates current account deficits; average repatriation rate of profits have been 70% in the region, and FDI inflows are either only as large as or even less than the repatriated profits in Hungary, Slovakia, and Czech Republic (Hunya, 2009).

Nine Eastern European economies in the EU have had a recession in 2009, Poland being the only exception (see table 2). Employment has declined and unemployment increased significantly in all countries, with the sharpest increases taking place in the Baltic Countries. Real wages have fallen in the Czech Republic, Hungary, the Baltic Countries, and Romania. The austerity programs in Hungary, Romania, and Latvia will further reinforce the pressures of the crisis. The wage share has already fallen in Latvia, Hungary, Poland, and the Czech Republic (see Figure 2). Moreover, a long-lasting recession cannot be ruled out, which would certainly have negative effects on the real wage and labour share.

Table 2

Figure 2

In the Eastern European economies the record of GDP, employment, and real wage growth over the past twenty years has been shocking (see table 2): first a transition recession and then a global crisis, the gains in terms of growth and wages are far from spectacular. Employment has at best stagnated, and it has decreased in Romania, Estonia, Lithuania, and Hungary compared to 1989. Real wages have stagnated in Hungary and Slovenia, even fallen in Lithuania and Bulgaria. Real wage growth has overall lagged behind productivity growth. The only significant real wage growth has taken place in Romania, but then only equal to



improvements in productivity. As a consequence of this moderate wage growth, which lags behind productivity, and low employment, the labour share has been declining in Slovenia, Poland, Bulgaria, and Romania and stagnant in Hungary and Slovakia (Figure 2). The only exception to that were the last years in the Baltic countries and Czech Republic, when the labour share was back to the levels at the starting of the transition; however data does not allow us to compare their current situation with the pre-transition phase; moreover as mentioned above, this recovery will be reversed during the current crisis. This does not look like a politically and socially viable balance sheet of integration.

The current global crisis has created no change in the policy stance regarding European enlargement. The concerns of the EU for the NMS are shaped by the interests of the multinational enterprises (MNEs), in particular Western banks, and are limited to maintaining the stability of the currency rather than employment and income. The EU did not have the political will to create the institutions and tools for a unified counter-cyclical stimulus plan, but rather delegated the issue of the NMS to the IMF, albeit with some financial support to prevent a big melt down of the Western European MNEs in the region. The IMF's injured credibility after the Asian crisis was restored at the G20 via an increase in the available funds to the IMF, but not much has changed in the policy framework, despite the seemingly different discourse. Faced with the pressure of capital outflows, Hungary, Latvia, and Romania have resorted to the IMF. The EU connection thanks to the interests of the MNEs, in particular West European banks in the region has determined the size of the packages rather than the genuine content. As it was in the case of the former crises in the developing countries in the 1990s and 2000s, the IMF policies are again much more restrictive than what IMF finds appropriate for the Western European countries. The credit line to Poland without conditionality is the only new tool the IMF has used. Otherwise Hungary, Romania, and Latvia are having strongly pro-cyclical fiscal policy; fiscal discipline is still the norm, and cuts in public sector wages and pensions are part of the recipes. In the fixed exchange rate countries the prevention of devaluation was the major aim to protect the foreign banks, which had extended the majority of the loans in foreign currency. The governments of these countries were also not willing to push domestic firms and households indebted in foreign currency into bankruptcy through devaluation. Thus nominal devaluation was replaced by a brutal internal real devaluation via wage suppression. In Latvia as of the fourth quarter of 2009, average salaries fell by 12.1%. Public sector wages were down by 23.7% compared to a year ago; pensions have been cut by 10%. Together with increases in the VAT rate from 18% to 21%, these were the conditions, which the government in Latvia had to agree to get the

second tranche of the IMF package (Gligorov et al., 2009). The government has forced through spending cuts and tax rises worth a tenth of GDP (Ward, 2010). The cost of this internal devaluation has been 25.0% loss of GDP in two years and 22.9% unemployment in 2009. Eventually it also translated into a political crisis as the biggest party, People's party, broke from the ruling coalition because of its support for the tax cuts. In Estonia and Lithuania also at least 20% cut in public wages and a reduction in social benefits was decided (Gligorov et al., 2009). Thus the current account imbalances are being corrected not through nominal but real devaluation and deep recession.

One difference during this crisis is that the IMF is now trying to bail in the banks to maintain the level of credits in the countries that have an IMF financial program. The major difference compared to East Asia and Latin America was reliance on parent banks in the mature markets with a longer term strategy of expansion in the region rather than market finance via foreign capital flows. The parent banks' loyalty to the region did not happen automatically though. For e.g. initially the Austrian government has said that it would only support its troubled Erste Bank, which was overexposed to risky loans in foreign currency in Eastern Europe, if the money went to loans inside Austria, thus not to further expansion of loans in the East (The Economist, March 2010c). This approach would have led to each individual bank reducing its exposure by calling in loans and dumping assets, and a major currency crisis, which would have hurt the banks themselves as well. The small number of large international players with a long term investment in the region facilitated coordination, and European Bank for Reconstruction and Development led the "Vienna Initiative." The ECB's liquidity provision to foreign banks in Eastern Europe encouraged them to keep financing the subsidiaries in outside the Euro area. The IMF support helped the Central Banks of Eastern Europe to provide liquidity to foreign owned banks as well as the minority domestic owned banks. However given the global crisis and the crunch in the wholesale credit markets, the ability of parent banks to maintain the credit booms in the region is exhausted, and even without further capital outflows, the region suffers from a deeper recession than in the West in the absence of former capital inflows. The speculation about the Greek sovereign debt is creating particular liquidity restraints for the Greek banks and their affiliates in Bulgaria and Romania; the funding problems of other European parent banks are also rising. The currency depreciation or the recession will lead to increases in non-performing loans and further affect the parent banks' approach to the Eastern affiliates.

Another difference in this crisis in the Eastern MS compared to the former crises in the developing countries was the moderate scale and pace of depreciation. In the countries with

the floating exchange rate regime, there has been some contagion even in countries like Poland, but not a total breakdown until now; the exchange rate only depreciated by 20-30% in Hungary, Poland, and Romania with some recovery afterwards, and the fixed pegs are still holding in the Baltic States and Bulgaria. The maintenance of the problematic pegs required rather large international rescue packages in comparison to the size of the economy. The Western European banks operating in the region, like the Swedish in the Baltic States and the Austrian in Bulgaria and their home country governments have pressurized to avoid devaluation in fear of high non-performing loan rates, which would erode their profitability. The local governments also stand behind the pegs. However, preserving this overvalued fixed exchange rate under the current policy framework came at the cost of a very deep recession and deflation to create a real devaluation, and the mechanism for that was massive wage cuts as can be seen in Latvia.

On the other hand the consequences of an unmanaged devaluation following a market-made currency crisis would lead to also very severe distributional effects, as was the case during the Asian or Latin American crises. The reason for that are the inflationary effects of high devaluation rates following a currency crisis. In import dependent developing countries, devaluation has a high pass through effect to domestic prices due to the rise in the imported input costs, and during a severe recession and high unemployment, it is impossible for workers to index their wages to past inflation rates (Onaran, 2009). So far during the recent global crisis, not only the depreciation rate has been moderate, but also the pass through effect to inflation has been restrained by the global deflationary environment and the falling commodity prices. However any problem in the periphery in Eastern or Western Europe or other developing countries regarding speculative attacks to sovereign debt and capital outflows can easily trigger contagion effects and pressures on currencies in Eastern Europe again.

Capital controls on outflows or a managed devaluation are not even mentioned in the IMF or EU debates. The only recent revision has been a recent “IMF Staff Position Note” about capital controls on inflows to moderate the effects on the exchange rate (Ostry et al, 2010); however this does not help at this moment when the boom has already been followed by a bust.

#### **4. An alternative economic policy framework for Europe**

The existing wage suppression policies hurt all working people alike. The popular discontent in Germany about Greece misses the fact that the German workers’ loss of wages, unemployment benefits, and pension rights created part of the problem. Uncovering this fact

along with the idea of unequal distribution as the main cause of the crisis is an important step towards building a progressive alliance for an alternative Europe. The attack is international: multinational bank and business lobbies are determining the policies of the governments and EU institutions by using boycotting of government bonds as a threat; thus the opposition also needs to be internationally organized. A pro-labour solution of the public debt crisis in the periphery as well as the core countries like Italy or Britain requires debt default, and a joint struggle can create a stronger offense to this multinational lobby. In that respect the EU could be turned into a leverage to bring together peoples' opposition to the budget cuts in different countries rather than being perceived merely as an obstacle despite its anti-democratic and technocratic structures. An internationalist solution might generate a more powerful front in the core and the periphery compared to national alternatives. Moreover in the current situation, anti-European and anti-Euro positions are more likely to mobilize nationalist, right-wing currents. Last but not least, the solution to the problems in the periphery of Europe would be tremendously facilitated by fiscal transfers within the EU as opposed to isolated national solutions in small countries, which can easily lead to a persistence of underdevelopment. This position is also consistent with the interests of the working people in the core countries: a low wage periphery as an alternative location for MNEs is a treat to the wages and jobs in the core as well.

Such a radical transformation of the EU requires a major change in the institutions and policy framework that places regional and social cohesion at the core of policy and builds a bridge from the urgent demands of people for decent living standards and a sustainable environment to an alternative anti-capitalist agenda. As the economic crisis intermingled with the ecological crisis demonstrates that capitalism is economically, ecologically, and politically unstable and unsustainable, policies for a change beyond capitalism offer themselves as opposed to reforms to "save capitalism from itself." Such policies build the bridge from today's urgent demands to the alternative of a democratic, participatory socialism.

In the concrete case of Greece, this paper differs from another position among left economists as suggested by Lapavitsas et al. (2010), which promotes the exit of Greece from the Eurozone based on an anti-capitalist agenda. Although this paper has a lot in common with Lapavitsas et al. (2010) regarding the anti-capitalist economic restructuring, we would prefer to push for an alternative Europe and changes in the economic policy framework within which the Euro operates for the reasons mentioned above.

In the following we discuss alternatives for fiscal policy, monetary policy, incomes and labour market policy, finance, and decision making within such an anti capitalist agenda for Europe.

The most important obstacle today to initiate any progressive economic policy in Europe is the speculation on public debt and the governments' commitment to satisfy the financiers. Public finance has to be unchained via debt default in both the periphery and the core. This has to be coordinated at the EU level as part of a broader public finance policy to make the responsible pay for the costs of crisis and to reverse the origin of the crisis, i.e. pro-capital redistribution. This involves a highly progressive system of taxes, coordinated at the EU level, on not only income but also wealth, higher corporate tax rates, inheritance tax, and tax on financial transactions. A progressive income tax mechanism could also introduce a maximum income with the highest marginal tax rate increasing to 90% above a certain income threshold in relation to the median wage. A progressive wealth tax on government bonds with the highest marginal tax rate reaching to 100% for holdings above a certain amount of bonds could be formulated as a way of restructuring the debt; this would make the banks, the private investment funds, and the high wealth individuals pay the costs of the fiscal crisis. The recognition of the need for default is also important given the ecological limits to growth, which poses a constraint to higher growth to ease debt repayment.

Fiscal policy should completely abandon Stability and Growth Pact, and public spending should aim at the multiple targets of full employment, ecological sustainability, equality, and convergence via generating public employment in labour intensive social services as well as public investments in ecological maintenance and repair, renewable energy, public transport, insulation of the existing housing stock and building of zero energy houses.

Monetary policy should be consistent with fiscal policy targets. The ECB should be turned into a real central bank with the ability to lend to member states. Higher public spending financed by monetary expansion does not pose a threat of inflation today given the recession, low demand, and deflationary environment. However it is important that monetary expansion serves the priorities of development, sustainability, full employment, and equality.

While keeping the Euro in the current Eurozone countries under the conditions outlined above is acceptable, in Eastern Europe, a direct transition from the pegged exchange rate to the Euro as is planned in Estonia or insistence in preserving the overvalued pegged exchange rate as in the case of Latvia, Lithuania, and Bulgaria is ignoring the need for a major adjustment in the exchange rate. Devaluation pushed by market forces would be devastating,

but this can be overcome with capital controls, debt restructuring and a managed devaluation with price controls. To avoid the negative effects of devaluation on indebted households and firms, the foreign currency denominated debt can be converted to local currency at the current exchange rate, and the burden of devaluation must be shifted to the private banks of the core countries. Similarly to avoid the inflationary effect of devaluation, price controls could be introduced. For the future the conditions of Maastricht treaty for adopting the Euro must be abolished and the process must be supported by policies of regional and social convergence.

On the incomes and labour market policy level, there is need for a fundamental correction of the wages in both the periphery and the core to reflect the productivity gains of the past three decades fully. To facilitate convergence a minimum wage should be coordinated at the EU level. Fiscal policy and incomes policy should also be coordinated: higher productivity growth in poorer countries of the EU will help to create some convergence in wages, but regional convergence should be supported by fiscal transfers and public investments to boost productivity in poorer regions. Furthermore a European unemployment benefit system should be developed to redistribute from low to high unemployment regions. This requires a significant EU budget financed by EU level progressive taxes.

To maintain full employment, a substantial shortening of working time, again coordinated at the EU level, in parallel with the historical productivity growth is also required. This is also an answer to the ecological crisis: if the use of environmental resources is to maintain a certain 'sustainable' level, economic growth, in the long term, has to be zero or low, i.e. equal to the growth rate of 'environmental productivity'. However, for such a regime to be socially desirable it has to guarantee a high level of employment and an equitable distribution of income; i.e. shorter working time and substantial redistribution via an increase in hourly wages and a decline in the profit share.

Regarding employment in the private sector, it is important to prevent firms from making use of the crisis to implement their long-term downsizing strategies. An alternative would be legal measures to ban firing during the crisis and implement wage floors: if the firing ban leads to bankruptcy in certain firms, these firms can be re-appropriated and revitalized under workers' control, supported by public credits. Widespread examples of that were seen in Argentina after the crisis in shut-down companies.

In cases of sectors that are under the threat of mass layoffs, like the auto industry, nationalization of the firms and restructuring of these public firms should be considered, e.g.

in the auto industry a shift of focus towards the production of public transport vehicles, and a gradual transfer of labour towards new sectors.

The redesign of the financial sector needs to be contextualized within these priorities of macroeconomic policy. Financial regulations including capital controls are important but not enough. Finance is a crucial sector which cannot be left to the short-termism of the private profit motive. This sector has already been de facto nationalized, but without any voice for the society and with a commitment to privatization as soon as possible. The crisis has shown us that large private banks are exploiting their advantage of being “too big to fail”. Yet the challenge is the finance of socially desirable large new investments, e.g. in the energy sector. Instead what needs to be done is to build a public banking sector with the participation of the workers and other stakeholders to decision making and the transparency of the accounts.

Finally this crisis calls for a major shift in decision making to facilitate economy wide coordination of important decisions. This in turn requires public ownership and the participation and control of the stakeholders (the workers in the firms, consumers, regional representatives etc.) in critical sectors for the society, such as banking, housing, energy, infrastructure, pension system, education, health.

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Table 1: Average annual growth in GDP, employment, productivity, and real wage, 1991-2009, Selected Western EU MS

	1991-2000				2000-2007			
	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage
Britain	2,98	0,55	2,42	1,70	2,56	0,88	1,66	1,50
Germany	1,75	0,15	1,60	1,39	1,24	0,21	1,03	-0,15
France	2,09	0,56	1,39	0,97	1,83	0,77	1,03	0,90
Italy	1,60	-0,15	1,65	-0,03	1,14	1,38	-0,21	-0,05
Spain	2,83	1,92	1,02	0,50	3,42	3,86	0,09	-0,80
Greece	2,26	1,34	0,91	1,04	4,20	1,41	2,75	2,28
Ireland	7,69	4,01	3,25	1,00	5,53	3,22	2,21	2,33
Portugal*	2,72	0,75	1,96	2,62	1,09	0,41	0,67	-0,11
Euro12**	2,12	0,61	1,50	0,81	1,86	1,16	0,69	0,07
	2008				2009			
	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage
Britain	0,55	0,76	-0,20	-0,59	-4,65	-2,09	-2,61	0,22
Germany	0,97	1,39	-0,42	0,56	-4,90	-0,09	-4,81	-1,62
France	0,32	1,39	-0,22	0,20	-2,30	-0,45	-1,21	0,38
Italy	-1,04	0,83	-1,35	-0,06	-4,80	-0,91	-3,98	-2,06
Spain	0,86	-0,48	1,48	3,35	-3,59	-6,77	2,92	3,57
Greece	2,01	1,10	0,91	0,49	-1,06	-1,19	0,14	3,53
Ireland	-3,02	-0,51	-1,92	5,12	-7,47	-8,18	0,10	1,73
Portugal*	-0,04	0,62	-0,66	0,66	-2,75	-2,40	-0,37	2,86
Euro12**	0,48	1,01	-0,53	0,56	-3,98	-1,60	-2,42	0,19

\*Real wage data for Portugal starts in 1995.

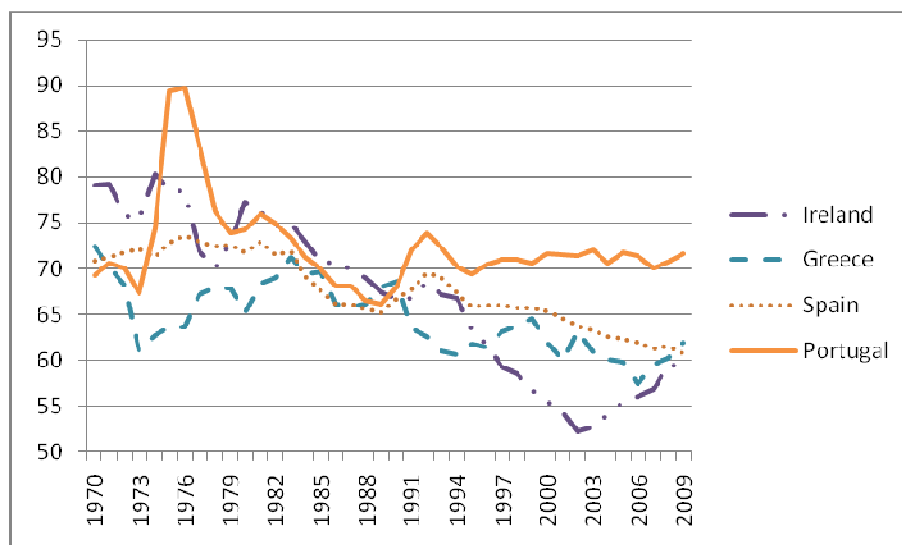
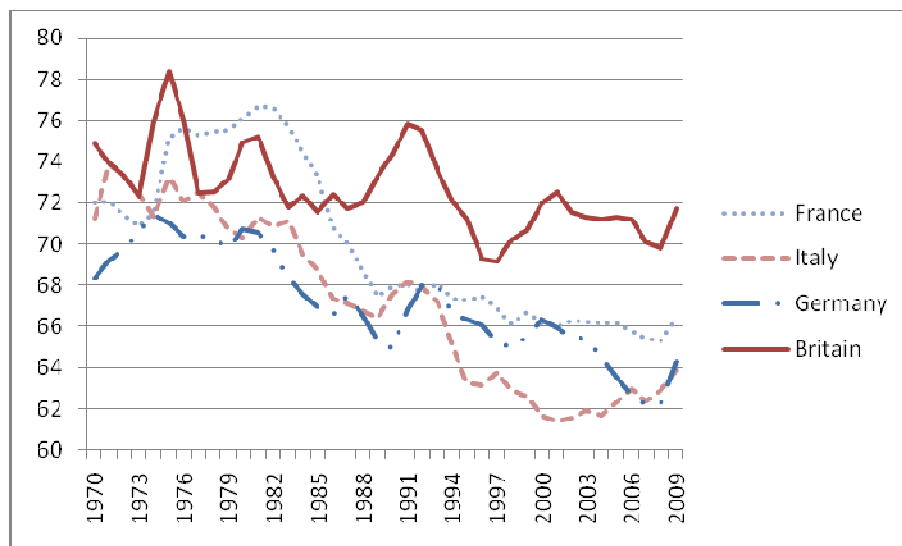
\*\*Euro12 refers to 12 old Euro area MS.

Employment is total economy. Productivity is Real GDP/Employee. Real wage is labour compensation deflated by private consumption deflator, index 2000=100.

Period averages are geometric averages.

Source: OECD Economic Outlook, online database, April 2010.

Figure 1a-b: Adjusted wage share, Selected Western EU MS\*



\*Compensation per employee as percentage of GDP at factor cost per person employed

Source: AMECO (Economic and Financial affairs, Annual Macroeconomic Indicators online database), April 2010

Table 2: Average annual growth in GDP, employment, productivity, and real wage, 1989-2009 and sub-periods, Eastern EU MS

	1989*-1994				1994-2000				2000-2007			
	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage
Czech Republic	-2,3	-2,0	-	-3,0	2,2	-0,8	3,2	3,2	4,5	0,8	3,8	4,7
Hungary	-3,2	-4,2	3,7	-1,9	3,3	0,5	2,1	-1,9	3,7	1,1	2,0	4,3
Poland	-1,6	-3,6	2,0	-3,5	5,7	-0,2	5,0	4,8	4,1	0,6	2,6	1,1
Slovenia	-2,3	-4,6	3,8	-6,0	4,3	-0,3	4,7	2,9	4,4	0,9	3,3	3,0
Slovakia	-2,4	-	12,6	-5,6	3,8	-0,6	4,8	5,3	6,2	1,0	5,9	3,3
Estonia	-1,6	-4,3	2,7	-17,3	6,0	-2,7	8,9	8,0	8,1	1,7	6,4	8,6
Latvia	-11,2	-5,1	19,0	8,2	4,3	-2,3	2,7	3,4	9,0	2,4	5,7	9,9
Lithuania	-11,5	-2,0	0,0	-19,8	4,5	-1,2	8,3	6,9	8,1	1,3	5,6	8,5
Bulgaria	-5,7	-5,8	8,5	-13,4	-0,2	0,0	0,0	-4,4	5,6	2,0	3,2	4,0
Romania	-4,6	-1,8	1,6	-6,7	0,1	-2,4	5,0	6,5	6,1	-0,8	5,5	9,3
	2008				2009				1989*-2009			
	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage	GDP	Employment	Productivity	Real wage
Czech Republic	2,5	1,2	1,1	1,3	-4,2	-1,2	-2,3	-1,1	1,5	0,1	2,9	2,1
Hungary	0,6	-1,3	1,6	0,9	-6,3	-3,6	-3,4	-4,5	1,2	-0,2	1,9	0,2
Poland	5,0	3,8	0,5	3,8	1,7	0,4	1,0	1,0	3,0	0,3	3,0	1,1
Slovenia	3,5	2,8	0,5	1,5	-7,8	-2,2	-5,4	4,0	2,0	0,3	3,2	0,6
Slovakia	6,2	2,8	4,1	1,3	-4,7	-2,4	-0,5	3,6	2,7	0,3	5,4	1,5
Estonia	-3,6	0,2	-5,1	0,6	-14,1	-9,9	-4,2	-2,2	4,4	-0,5	5,6	1,4
Latvia	-4,6	0,9	-6,2	-1,0	-18,0	-13,6	-3,7	-14,6	0,1	0,0	4,8	5,0
Lithuania	2,8	-0,5	0,7	2,9	-15,0	-6,9	-8,1	-11,5	0,3	-0,2	5,0	-1,1
Bulgaria	6,0	3,3	2,3	7,4	-5,0	-2,9	-0,9	6,9	0,4	0,6	3,2	-2,9
Romania	7,3	-0,2	6,7	13,5	-7,1	-1,0	-6,1	-0,1	0,9	-0,8	3,9	4,0

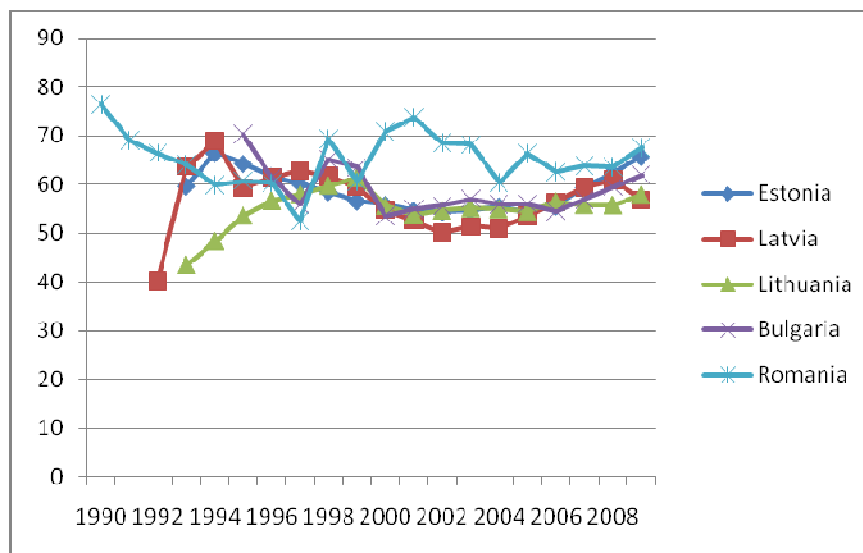
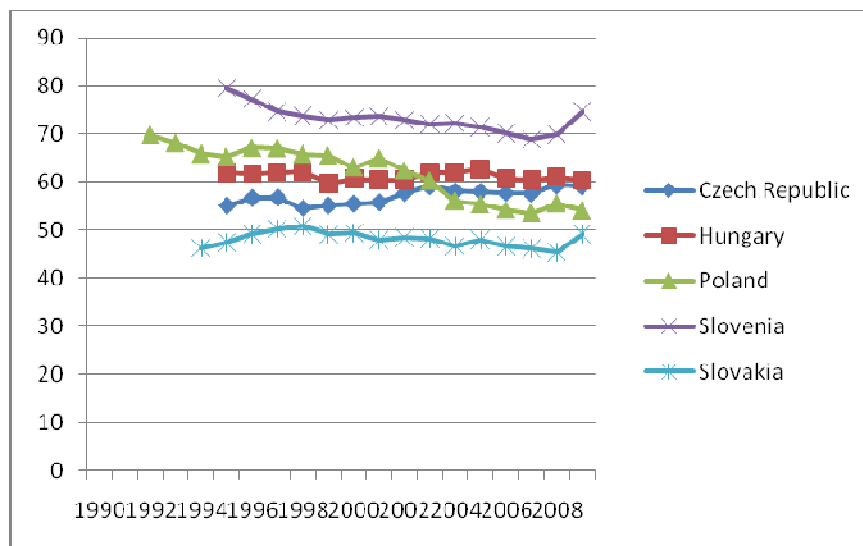
Notes: The starting date differs with respect to data availability. GDP data is only starting in Estonia in 1993, the employment data starts in Slovakia in 1994, in Hungary in 1992, and in Estonia in 1990, the employee data starts in 1995 in Czech Republic, in 1992 in Hungary and Latvia, in 1993 in Slovakia, Estonia, and Lithuania, in 1990 in Romania and the wage data starts in Latvia in 1993 and in Estonia in 1990.

GDP is in 2000 prices in national currencies. Employment is total economy. Productivity is Real GDP/Employee. Real wage is labour compensation deflated by private consumption deflator, index 2000=100.

Period averages are geometric averages. The data for 2009 is AMECO forecast as of April 2010.

Source: Own calculation based on AMECO (Economic and Financial affairs, Annual Macroeconomic Indicators online database); in case of the missing values for 1989-1991 growth rates of the variables in WIIW (The Vienna Institute for International Economic Studies), Handbook of Statistics, online database is used.

Figure 2: Adjusted wage share, Eastern EU MS\*



\*Compensation per employee as percentage of GDP at factor cost per person employed

Source: AMECO (Economic and Financial affairs, Annual Macroeconomic Indicators online database), April 2010.